



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

4 September 2009

Our ref: ICAEW Rep 95/09

Your ref: CEIOPS-CP-40/09

CEIOPS e.V
Westhafenplatz 1
60327 Frankfurt
Germany

Dear Sir or Madam

Draft CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions - Article 85 b- Risk-free interest rate term structure

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on *Draft CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions - Article 85 b- Risk-free interest rate term structure*. We provide our comments in your preferred template at Appendix 1.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

Dr Claire Stone ACA
Manager, Audit & Reporting
Financial Services Faculty
T +44 (0)20 7920 8446
F +44 (0)20 7920 6009
E claire.stone@icaew.com



**THE INSTITUTE
OF CHARTERED
ACCOUNTANTS**
IN ENGLAND AND WALES

ICAEW REPRESENTATION

ICAEW REP 95/09

DRAFT CEIOPS ADVICE FOR LEVEL 2 IMPLEMENTING MEASURES ON SOLVENCY II: TECHNICAL PROVISIONS - ARTICLE 85 B- RISK-FREE INTEREST RATE TERM STRUCTURE

Memorandum of comment submitted in September 2009 by The Institute of Chartered Accountants in England and Wales, in response to CEIOPS consultation paper 40, 'Draft CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions - Article 85 b- Risk-free interest rate term structure' published in July 2009

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the consultation paper 40, *Draft CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions - Article 85 b- Risk-free interest rate term structure* published by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide. The Institute is listed in the European Commission's Register of Interest Representatives (reference 7719382720-34).
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.
4. The Institute's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest. It draws together professionals from across the financial services industry and from the 25,000 members specialising in the sector. This includes those working for regulated firms, in professional service firms, intermediaries and regulators.

MAJOR POINTS

5. Our main concern with the Consultation Paper is that it recommends that Government bonds be used as the proxy for a risk free rate, and for the reasons set out below, we would prefer that the swap rate, which was used in Quantitative Impact Study 4, continue to be used.

RESPONSES TO SPECIFIC POINTS

Three stage approach for the derivation of risk-free interest rates (3.1.2)

6. We do not agree that the credit standing of an AAA rated government should necessarily serve as the benchmark risk free rate. A key reason for this is the potential mismatch between supply and demand for AAA bonds which can lead to price dislocation and result in rates based on them not being true risk free rates. In particular, the current dislocation of the credit markets and stress put on specific economies has made sovereign debt volatile and therefore not necessarily the best proxy for a risk free rate. It is not clear what will happen in jurisdictions where appropriate Government bond rates are not available. We note that this approach would be heavily reliant on the work of credit ratings agencies and would be interested in understanding the implications for technical provisions of a change to Government bond ratings.
7. We acknowledge that there is more credit risk associated with swaps but still think these provide an appropriate benchmark. The credit risk associated with swaps is reduced by requirements for collateral and the role of clearing banks in exchanging, settling and clearing. Swaps are a margin transaction, making them more liquid than Government bonds, including at times when capital markets are constrained. The supply and demand mismatch that is

affecting Government bonds at the current time does not affect swaps in the same way. Finally, swaps are available for a wider range of future durations, allowing a wider spectrum yield curve.

8. We think that consistency between different insurers will be important, and that it would be better to set out the process for the interest rate term structures for the different currencies at Level 2 rather than at Level 3 (paragraph 3.28).

Illiquidity premium (3.1.3)

9. We agree that the issue of the illiquidity premium merits further consideration. Arguments in favour of an illiquidity premium include the fact that savers get higher returns when they are investing for longer periods. Whilst it would not be appropriate to include an illiquidity premium for policies which are highly liquid (for example, a unit linked policy without a surrender penalty), where policies are demonstrably illiquid, we believe allowance for the illiquidity should be reflected in the determination of the liabilities. Making an illiquidity adjustment to the discount rate is one means of achieving this.
10. For example, for UK annuities which provide a fixed regular income until death with no surrender value, we consider the economic reality is better captured by including an illiquidity premium rather than using the same liquid risk free term structure applied to other insurance liabilities. It appears that the CEIOPS advice in this respect may be introducing prudence into the calculation of technical provisions rather than aiming to capture the underlying economic picture. Further work would be needed to establish how to estimate the illiquidity premium.
11. In its development of a new standard for accounting for insurance contracts, the IASB is currently considering whether to include an illiquidity premium; consistency between Solvency II and IFRS in this area would be helpful to both preparers and users.

Relevant risk-free interest rate term structure for other currencies (3.1.5)

12. Again, to better promote a uniform approach by insurers throughout the EU, we consider that the basis for discounting overseas currencies should be in Level 2 guidance, not Level 3 as proposed in the Consultation Paper (paragraph 3.37).

E claire.stone@icaew.com

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Comments Template on CEIOPS-CP 40 Consultation Paper on the Draft L2 Advice on TP – Risk free interest rate		Deadline 11.09.2009 4 p.m. CET
Name of Company:	ICAEW	
Disclosure of comments:	CEIOPS will make all comments available on its website, except where respondents specifically request that their comments remain confidential. Please indicate if your comments should be treated as confidential:	No
<p>The numbering of the paragraphs refers to Consultation Paper No. 40 (CEIOPS-CP-40/09).</p>		

Reference	Comment	
General Comment	Our main concern with the Consultation Paper is that it recommends that Government bonds be used as the proxy for a risk free rate, and for the reasons set out below, we would prefer that the swap rate, which was used in Quantitative Impact Study 4, continue to be used.	
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3.22.	<p>We do not agree that the credit standing of an AAA rated government should necessarily serve as the benchmark risk free rate (3.1.2). A key reason for this is the potential mismatch between supply and demand for AAA bonds which can lead to price dislocation and result in rates based on them not being true risk free rates. In particular, the current dislocation of the credit markets and stress put on specific economies has made sovereign debt volatile and therefore not necessarily the best proxy for a risk free rate. It is not clear what will happen in jurisdictions where appropriate Government bond rates are not available. We note that this approach would be heavily reliant on the work of credit ratings agencies and would be interested in understanding the implications for technical provisions of a change to Government bond ratings.</p> <p>We acknowledge that there is more credit risk associated with swaps but still think these provide an appropriate benchmark. The credit risk associated with swaps is reduced by requirements for collateral and the role of clearing banks in exchanging, settling and clearing. Swaps are a margin transaction, making them more liquid than Government bonds, including at times when capital markets are constrained. The supply and demand mismatch that is affecting Government bonds at the current time does not affect swaps in the same way. Finally, swaps are available for a wider range of future durations, allowing a wider spectrum yield curve.</p>	

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3.28.	We think that consistency between different insurers will be important, and that it would be better to set out the process for the interest rate term structures for the different currencies at Level 2 rather than at Level 3 (paragraph 3.28).	
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3.30.	<p>We agree that the issue of the illiquidity premium merits further consideration. Arguments in favour of an illiquidity premium include the fact that savers get higher returns when they are investing for longer periods. Whilst it would not be appropriate to include an illiquidity premium for policies which are highly liquid (for example, a unit linked policy without a surrender penalty), where policies are demonstrably illiquid, we believe allowance for the illiquidity should be reflected in the determination of the liabilities. Making an illiquidity adjustment to the discount rate is one means of achieving this.</p> <p>For example, for UK annuities which provide a fixed regular income until death with no surrender value, we consider the economic reality is better captured by including an illiquidity premium rather than using the same liquid risk free term structure applied to other insurance liabilities. It appears that the CEIOPS advice in this respect may be introducing prudence into the calculation of technical provisions rather than aiming to capture the underlying economic picture. Further work would be needed to establish how to estimate the illiquidity premium.</p> <p>In its development of a new standard for accounting for insurance contracts, the IASB is currently considering whether to include an illiquidity premium; consistency between Solvency II and IFRS in this area would be helpful to both preparers and users.</p>	
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3.37.	<p>Again, to better promote a uniform approach by insurers throughout the EU, we consider that the basis for discounting overseas currencies should be in Level 2 guidance, not Level 3 as proposed in the Consultation Paper (paragraph 3.37).</p>	
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